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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. .....

PRUDENCE-BONDS CORPORATION (NEW CORPORATION), SUCCESSOR TRUSTEE OF PRUDENCE-BONDS CORPORATION, DEBTOR, GEORGE E. EDDY AND ADA S. BEARDSLEY, PETITIONERS,

VS.

STATE STREET TRUST COMPANY, AS TRUSTEE OF PRUDENCE-BONDS, TENTH SERIES, UNDER TRUST AGREEMENT DATED MAY 1, 1927, WITH PRUDENCE-BONDS CORPORATION.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petitioners, Prudence-Bonds Corporation (New Corporation), the Successor Trustee of Prudence-Bonds Corporation, Debtor, George E. Eddy and Ada S. Beardsley, respectfully pray that a writ of certiorari issue to review the judgment or decree of the United States Court of Appeals for the Second Circuit entered March 3, 1953, affirming a decree of the United States District Court for the Eastern District of New York entered April 2, 1951, in proceedings for the reorganization of Prudence-Bonds Corporation, Debtor, under the Bankruptcy Act (R. 11, 1237).

Opinions Below

The majority and dissenting opinions of the Court of Appeals for the Second Circuit (R. 1197, 1212) are reported in 202 F. 2d 555, 558, 564.

The opinion of the District Court (R. 461) is reported in 101 F. Supp. 729.

The opinion of the Special Master is not reported but is printed in the record (R. 278).

Jurisdiction

The judgment or decree of the United States Court of Appeals for the Second Circuit was entered on March 3, 1953 (R. 1237). A petition for rehearing filed in that Court by petitioners (R. 1239) was denied on March 31, 1953 (R. 1266, 1268). By order of this Court entered May 26, 1953, the time for filing a petition for a writ of certiorari was extended to and including July 29, 1953 (R. 1271).

The jurisdiction of this Court is invoked under 28 U. S. C. Sec. 1254, and Sec. 24(c) of the Bankruptcy Act, as amended, 11 U. S. C. Sec. 47(c).

Questions Presented

In a proceeding for reorganization of a corporation under the Bankruptcy Act an indenture trustee, in aid of carrying out a confirmed Plan of Reorganization, accounted to the bankruptcy court for its acts as trustee under a trust indenture creating a trust fund securing an issue of bonds of the Debtor. Objection was made to the account upon the ground that the indenture trustee caused the trust fund to suffer a substantial loss by a devastavit of nonfeasance in failing to protect and enforce a security constituting a major part of the trust *res*. The issue was

tried before a Master who sustained the objection and surcharged the indenture trustee $1,169,424.44, plus interest. The District Court, without passing upon the merits of the cause, dismissed the objection upon the ground that the bankruptcy court had no jurisdiction of the subject matter. The Court of Appeals first affirmed, holding that the bankruptcy court had no jurisdiction. On rehearing, the Court of Appeals vacated its judgment of affirmance, held that the bankruptcy court had jurisdiction and affirmed the decree upon the merits of the cause.

The questions are:

1. Whether on an appeal from a decree of a federal district court dismissing a bankruptcy cause for lack of jurisdiction, the Court of Appeals, upon deciding that the bankruptcy court had jurisdiction, is empowered to affirm the decree upon the merits of the cause not determined by the decree?

The following additional questions presented would not require consideration if this Court, on granting certiorari, should answer question No. "1" in the negative and remand the cause to the District Court to pass upon the merits.

2. Whether a bankruptcy court in a corporate reorganization proceeding has jurisdiction to enforce for the benefit of bondholder secured creditors as a class the liability of an indenture trustee for a devastavit of nonfeasance in failing to protect and enforce a security constituting part of a trust *res* securing an issue of bonds of the Debtor?

3. Whether the rule of *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, applies where the jurisdiction of the federal court is based upon the Bankruptcy Act and not upon diversity of citizenship?

4. Whether, if state law controls the bankruptcy court, the controlling law is that of the state where the bank-

ruptcy court sits, or the state where the trust indenture was executed and to be performed by the indenture trustee?

5. Whether a trust indenture provision giving complete immunity to a professional indenture trustee against liability for any nonfeasance with respect to a trust *res* securing a public issue of corporate bonds is ineffective and contrary to public policy?

6. Whether the majority of the Court of Appeals erred in construing the trust indenture to provide for complete immunity to the trustee against liability for any nonfeasance with respect to the trust *res*?

Statute Involved

The pertinent provisions of the Bankruptcy Act, as amended, are set forth in the Appendix, *infra*, pp. 25-27.

Statement

This case involves the reorganization of Prudence-Bonds Corporation, Debtor, under the Bankruptcy Act, and, more particularly, a summary proceeding had in the bankruptcy court, Eastern District of New York, for the judicial settlement of the account of State Street Trust Company of Boston, Massachusetts, trustee under a trust indenture with the Debtor securing a Series of the Debtor's bonds known as "Tenth Series" (R. 36-78).

When the Debtor, a New York corporation, filed its petition for reorganization it had outstanding 83,000 bonds of 18 Series aggregating $56,000,000.00, held by 30,000 persons residing in New York State and elsewhere throughout the United States and in foreign countries (R. 324). Each Series was secured by a trust fund, consisting of mortgages, cash and other securities, held by a Bank as trustee under a trust indenture with the Debtor (R. 320-321).

The Debtor was found to be insolvent and a Plan of Reorganization was confirmed which provided, in part, for a new corporation (also named Prudence-Bonds Corporation) to be owned by the bondholders, an extension of the maturity of the bonds and changes in interest provisions (R. 324-326). Eleven Banks were trustees of the 18 Series of bonds (R. 81-82). Under the Plan, one of the Banks became trustee of all Series under a supplemental trust indenture with the new Prudence-Bonds Corporation (R. 326-327).

Upon confirmation, jurisdiction was retained to carry out the Plan (R. 325). To that end the bankruptcy court, among other things, approved the appointment of the successor indenture trustee, approved the supplemental trust indenture, and directed the original indenture trustees to transfer the trust funds to the successor trustee and to account in the reorganization proceeding for their acts as trustees (R. 326-328).

Each of the indenture trustees submitted to the jurisdiction of the bankruptcy court, filed its account and petitioned for the judicial settlement thereof and a discharge from all liability (R. 328). The jurisdiction of the bankruptcy court over the accountings was upheld in *Central Hanover B. & T. Co.* v. *President & Directors of the Manhattan Co.*, 105 F. 2d 130 (C. A. 2). On the mandate of the Court of Appeals in that case, the bankruptcy court decreed that it had and thereby exercised "full complete and exclusive jurisdiction" to settle the accounts and to hear and determine "any and all objections thereto" (R. 81-82). Objections to the accounts were filed and there then ensued further litigation in the proceedings which resulted in three other decisions of the Court of Appeals reported as *Manufacturers Trust Co.* v. *Kelby*, 125 F. 2d 650 (C. A. 2), cert. den., 316 U. S. 697; *Brooklyn Trust Co.* v. *Kelby*, 134 F. 2d 105 (C. A. 2), cert. den., 319 U. S. 767, and *President & Directors of the Manhattan Co.* v. *Kelby*, 147 F. 2d 465 (C. A. 2), cert. den., 324 U. S. 866.

In both the *Manufacturers Trust Company* and the *Brooklyn Trust Company* cases the Court of Appeals reaffirmed its decision in the *Central Hanover* case that the bankruptcy court had jurisdiction. In the *President & Directors of the Manhattan Co.* case, the Court of Appeals upheld upon the merits a very substantial surcharge against that Bank which was trustee of two Series of the Debtor's bonds. In most other Series the objections were settled and compromised with the approval of the bankruptcy court (R. 1243-1244). In one case a settlement was upheld by the Court of Appeals (*Eddy* v. *Kelsey,* 148 F. 2d 323, C. A. 2). The recovery obtained in each case, whether by surcharge or settlement, became a part of the trust *res* securing the bonds and enured to the benefit of all bondholders of the Series. The final decree of the bankruptcy court in each of the other accountings judicially settled, as adjusted, the account of the indenture trustee and released it of all liability as trustee.

State Street Trust Company, the accounting trustee in the instant case, is a Massachusetts banking corporation with offices in Boston (R. 39). It became trustee of the Debtor's Tenth Series bonds under a trust indenture with the Debtor dated May 1, 1927 (R. 726). The trust was accepted and became effective when executed by the trustee in Boston (R. 767-769); the situs of the trust fund was the office of the Bank in Boston; the bonds secured by the trust fund were "not valid for any purpose until authenticated" by the indenture trustee; they were authenticated and delivered in Massachusetts, marketed through Estabrook & Co. of Boston and payable at the Boston office of Estabrook & Co. (R. 738, 740, 783, 1109).

State Street Trust Company, like the other indenture trustees, filed its account in the Debtor's reorganization proceeding in New York, and petitioned the bankruptcy court for a judicial settlement thereof and a discharge from all liability as trustee (R. 39, 43, 320, 329-330).

Objections to the account were duly filed by the new Prudence-Bonds Corporation and the Reorganization Trustees of the Debtor and were joined in by individual bondholders (R. 85, 330-331). The account and objections were referred to a Master to take testimony and to hear and report on the facts and the law with his opinion thereon (R. 278).

The main objection to the account, the objection here material, sought a surcharge against the indenture trustee for breach of trust in failing to protect and enforce a guarantee made by The Prudence Company, Inc. (an affiliate of the Debtor) to the indenture trustee, guaranteeing payment of principal and interest of all mortgages in the trust fund securing the Tenth Series bonds (R. 88-90, 296-310). At the trial it was established, and the Master found, that the trust indenture expressly provided for this guarantee, that the guarantee was executed by the Guarantor and duly delivered to the indenture trustee, that one of the mortgages constituting 85% of the entire trust *res* was, to the knowledge of the indenture trustee, in default at all times from May 28, 1929, that the mortgage was foreclosed and the mortgaged premises ultimately sold at a loss of $1,162,424.44, that the Guarantor, in February, 1935, went into bankruptcy reorganization and was found to be insolvent, and that the indenture trustee, although the legal and sole owner of the guarantee, did not at any time make any demand or claim or take any step or action to enforce the guarantee while the Guarantor was solvent or after the Guarantor went into reorganization (R. 296-310, 349-350, 355-366, 370-376).

The Master sustained the objection and surcharged State Street Trust Company in the sum of $1,169,526.74, plus interest (R. 388-389).

The District Court, without passing upon the merits of the objection, overruled the Master and dismissed the objection upon the grounds that the guarantee, although ex-

pressly provided for by the trust indenture, was not part of the trust *res*, and that a bankruptcy court, in a corporate reorganization proceeding, has no jurisdiction to surcharge an indenture trustee for a devastavit of nonfeasance (R. 469-472; 101 F. Supp. 729).

Petitioners, the Objectors to the account, appealed the decree of the District Court (Inch, J.) entered April 2, 1951 (R. 5, 16). Petitioners urged that the bankruptcy court had jurisdiction and that if the Court of Appeals reversed it should direct the entry of the judgment which the District Court ought to have granted. The indenture trustee took the position that it was not called upon to detail in its brief on the appeal various issues pertaining to the merits for the reason that they involved consideration of "complicated facts upon which the District Court declined to pass".

The Court of Appeals affirmed with an opinion, dated December 5, 1951, written by Judge Frank and concurred in by Chief Judge Swan and District Judge Coxe (R. 1112-1115; 202 F. 2d 556). The Court of Appeals, assuming that the guarantee was part of the trust *res*, held that the jurisdiction of the bankruptcy court was controlled by the law of New York regarding the nature of the liability of a trustee of a trust fund securing bonds; that in New York, particularly since *Smith* v. *Continental Bank* (1944), 292 N. Y. 275, the liability of such a trustee for a devastavit of misfeasance is to restore the lost trust *res* and is enforceable derivatively in the right of the trust for the benefit of all bondholders as a class, whereas, a devastavit of nonfeasance gives rise only to personal causes of action for damages in favor of the persons who owned the bonds at the time of the nonfeasance; that, accordingly, the bankruptcy court, while having jurisdiction in a case of misfeasance where the recovery goes to restore the *res*, has no

jurisdiction over the personal causes of action arising in the case of nonfeasance (202 F. 2d 556-557).

The Court of Appeals was of the opinion that the rule of *Smith* v. *Continental Bank, supra,* was unsound and peculiar to New York law, but held that it was controlled thereby (202 F. 2d 556-557); See footnote 8, *infra,* pp. 18-19).

Petitioners duly applied for rehearing and, in addition to contending that the Court of Appeals misinterpreted New York law, urged that state law does not control a bankruptcy court exercising, in a corporate reorganization proceeding, its express and inherent powers to enforce accountings under and to satisfy trust indentures; that, even if state law governed, the controlling state, on the facts of this case, would not be New York, where the bankruptcy court sits, but Massachusetts where the trust indenture was executed and to be performed by the indenture trustee; that Massachusetts decisions dealing with the liability of trustees for bondholders treated such a trustee the same as any other trustee and were contrary to the law of New York as construed by the Court of Appeals (R. 1119-1147).

The Court of Appeals granted rehearing and the appeal, originally heard by Chief Judge Swan, Judge Frank and District Judge Coxe, was reheard on oral argument and briefs, limited to the issue of jurisdiction, before Judges Swan, Learned Hand and Frank (R. 1112, 1125-1196, 1197).

On March 3, 1953, fifteen months after rendering its decision of December 5, 1951, the Court of Appeals, by a majority opinion of Judge Learned Hand, vacated its original judgment, held that the bankruptcy court had jurisdiction, but again affirmed the decree on appeal, this time upon grounds involving the merits of the cause which had not been passed upon by the District Court (R. 1197-1212; 202 F. 2d 558).

The majority of the Court of Appeals, avoiding any decision as to what law governed the issue of jurisdiction, decided, upon certain assumptions, that the bankruptcy court had jurisdiction sufficient to warrant the Court of Appeals considering the cause upon the merits, and, upon so doing, concluded that the intent of an ambiguous provision of the trust indenture was to give the indenture trustee complete immunity against liability for any nonfeasance with respect to the trust *res* (R. 1197-1212; 202 F. 2d 558).

The majority Judges relied upon their interpretation of the wording of Sec. 1 of Article V of the trust indenture (R. 1204, 1206; 202 F. 2d 561),[1] and resolved their stated speculations and admitted doubts about the meaning of such Section in favor of the indenture trustee (R. 1206-1211; 202 F. 2d 561-564). The majority opinion clearly indicates that the majority Judges believed that the indenture trustee had invoked such Section as an excuse (R. 1204; 202 F. 2d 561),[2] whereas, the indenture trustee, although represented in the Court of Appeals by the same attorneys who had represented it when the indenture was drafted and executed, did not in its brief in the Court of Appeals even mention, let alone invoke, Sec. 1 of Article V (R. 1253).

Judge Frank, who wrote the original unanimous opinion of the Court of Appeals, vigorously dissented holding that the Court's original decision on the issue of jurisdiction was entirely erroneous, that the bankruptcy court had full

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[1] The majority opinion, referring to another section of the indenture, states (R. 1205; 202 F. 2d 561):

> "* * * If this (the other) section stood alone, we might hesitate to say that it created an excuse. However, when read in conjunction with Sec. 1 of Article V, it confirms our conclusion, *depending upon that section,* that the Trustee meant to obtain a general immunity from any liability for nonfeasance." (Italics ours.)

[2] The majority opinion states: "The Trustee invokes three clauses of the Indenture to excuse its failure to enforce this Guaranty; * * * (3) § 1 of Article V" (R. 1204; 202 F. 2d 561).

jurisdiction, that the indenture trustee is liable to restore the loss to the trust *res* resulting from its nonfeasance, that the trust indenture does not contain any provision immunizing the trustee against such liability, that even if it did the provision would be ineffective and contrary to public policy, that the majority decision "debases" the word "trustee", is "without precedent" and "contrary to the precedents" (R. 1212, 1216, 1222, 1234; 202 F. 2d 564, 569, 575).

Specification of Errors to be Urged

The Court of Appeals erred:

1. In affirming the decree on appeal upon the merits of the cause which were not determined by the decree.

2. In not reversing the decree on appeal and remanding the cause to the District Court for determination upon the merits.

The following additional assignments of error relate to the questions presented other than question No. "1", and would not require consideration if such question were answered in the negative.

The Court of Appeals erred:

3. In holding that the jurisdiction of the bankruptcy court depended upon whether the bondholder secured creditors on the date the Debtor's petition for reorganization was filed included some at least who purchased their bonds before the date the indenture trustee's nonfeasance commenced.

4. In not holding that the liability of the indenture trustee for its devastavit of nonfeasance with respect to the trust *res* is to restore to the trust fund the value of the

lost trust property, that the right to enforce such liability constitutes property of the Debtor within the meaning of the Bankruptcy Act, and that the bankruptcy court, on the accounting by the indenture trustee, had full jurisdiction to enforce such liability for the benefit of the bondholder secured creditors as a class.

5. In not holding that the rule of *Erie R. Co.* v. *Tompkins,* 304 U. S. 64, does not apply where the jurisdiction of the federal court is based upon the Bankruptcy Act.

6. In not holding that if state law controlled the bankruptcy court in determining the nature of the liability of the indenture trustee the controlling law, on the facts of this case, is the law of Massachusetts.

7. In construing the trust indenture to provide for complete immunity to the indenture trustee against liability for any nonfeasance with respect to the trust *res.*

8. In not holding that a trust indenture provision giving complete immunity to an indenture trustee for any nonfeasance with respect to a trust *res* securing a public issue of corporate bonds is ineffective and contrary to public policy.

9. In not reversing the decree on appeal and holding that the indenture trustee is liable for its devastavit of nonfeasance as recommended by the Report of the Master.

Reasons for Granting the Writ

1. The decision below presents an important question regarding the jurisdiction of United States Courts of Appeals which should be resolved by this Court. In deciding upon the merits a cause which the District Court did not decide upon the merits the Court of Appeals probably

exceeded its powers and determined the cause in a way probably in conflict with the provisions of the Bankruptcy Act and decisions of other Federal Courts of Appeals.

The Bankruptcy Act, Sec. 24(a), 11 U. S. C. Sec. 47(a), invests Courts of Appeals with "appellate jurisdiction • • • to review, affirm, revise, or reverse, both in matters of law and in matters of fact".

Where, as here, a court of bankruptcy has dismissed a cause for lack of jurisdiction, without passing upon the merits as a matter of fact or law, there is no judgment upon the merits to "review, affirm, revise, or reverse".

In *McDonald* v. *Smalley*, 1 Pet. 620, 621, where the record contained the whole of the proceedings and exhibited all matters required for a final disposition of the cause, this Court, when asked for instructions, and "having been advised upon the subject, directed counsel to argue the point of jurisdiction only, as no other than that had been decided in the court from which the appeal had been taken".

In *Tucker* v. *Dr. P. Phillips Co.*, 148 F. 2d 904 (C. A. 5), the Court stated, p. 907:

> "• • • Since the court below did not consider the merits of the counterclaims or any questions of set-off that may arise in connection therewith, the ultimate rights and liabilities of the sub-lessor and the trustee of the bankrupt may not be determined on this appeal. These are matters upon which the trial court must first rule."

In *Stephenson* v. *Equitable Life Assur. Soc.*, 92 F. 2d 406 (C. A. 4), the Court stated, p. 410:

> "• • • In reversing the dismissal on the jurisdictional point there is nothing that we can do but remand the cause for further proceedings. We have been urged to interpret the incontestable clause of the policy; but our powers are solely those of an appellate court, and we can pass upon the merits of a cause only by way of review."

There are many other cases in accord with this principle of appellate jurisdiction.[3]

Other cases hold that, except on appeals involving jury verdicts, a Court of Appeals is empowered, when it reverses a cause, to direct the entry of a proper judgment in the lower court and thus terminate the litigation upon the merits.[4]

The Court of Appeals in the instant case did not reverse the decree on appeal, nor did it direct any action by the District Court; it affirmed upon the merits of the cause, but in affirming reversed the decision of the District Court dismissing the cause for lack of jurisdiction (R. 1235, 1237). The Court of Appeals thus assumed original jurisdiction of the cause upon the merits; it did what this Court declined to do in *McDonald* v. *Smalley, supra;* what the *Tucker, Stephenson* and other cases cited *supra* hold Courts of Appeals are not empowered to do even when urged by parties.

Appeal does not lie from a report of a Special Master; the report must first be passed upon by the District Court.[5] The unusual result of the instant case is that the Master's Report, determining the cause upon the merits in favor of petitioners, has in effect been reversed in the

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[3] *Hudson* v. *Newell,* 172 F. 2d 848, 850 (C. A. 5); *Amick* v. *Columbia Casualty Co.,* 101 F. 2d 984 (C. A. 8); *Purcell* v. *Summers,* 126 F. 2d 390, 395-396 (C. A. 4); *Farm Bureau Mut. Automobile Ins. Co.* v. *Daniel,* 92 F. 2d 838, 839 (C. A. 4); *Ironite Co.* v. *Guarantee Waterproofing Co.,* 64 F. 2d 608, 609 (C. A. 8); *Hatch* v. *Morosco Holding Co.,* 50 F. 2d 138, 141 (C. A. 2); *Moonblatt* v. *Kosmin,* 139 F. 2d 412, 415 (C. A. 3); *Pike's Peak Hydro-Electric Co.* v. *Power & Mining Machinery Co.,* 165 Fed. 184 (C. A. 8); Cf., *Okla. Gas Co.* v. *Russell,* 261 U. S. 290; *O'Leary* v. *Brown-Pacific-Maxon,* 340 U. S. 504.

[4] *Thornton* v. *Carter,* 109 F. 2d 316, 319 (C. A. 8); *Herzberg's Inc.* v. *Ocean Acc. & Guarantee Corp.,* 132 F. 2d 438, 441 (C. A. 8).

[5] General Order in Bankruptcy 47; F. R. C. P. 53; *Moonblatt* v. *Kosmin,* 139 F. 2d 412 (C. A. 3).

Court of Appeals in favor of the indenture trustee on an appeal taken by petitioners.

This cause, involving issues of substantial importance to the investing public, as well as to the parties, has, therefore, been determined upon the merits without the due process of a determination upon the merits by a District Court.

The possibility of a miscarriage of justice inherent in the assumption of such power by Courts of Appeals is emphasized by this case. The cause has been determined in favor of the indenture trustee upon the merits; (a) without any decision thereon by the District Court; (b) by a tie vote of the Master and the three Judges of the Court of Appeals; (c) by a majority opinion of a Judge who sat only on the rehearing on the issue of jurisdiction; and (d) upon a point not relied upon by the indenture trustee in the Court of Appeals (Statement, *supra*, pp. 8-11).

2. The Court of Appeals has rendered a decision on an important question of jurisdiction of courts of bankruptcy in corporate reorganization proceedings probably in conflict with provisions of the Bankruptcy Act and decisions of Courts of Appeals for the Second and Third Circuits. The question is of importance in the administration of the Bankruptcy Act and effects a large segment of the investing public holding corporate bonds secured by trust indentures.

The Court of Appeals, reversing the District Court, has held that the bankruptcy court had jurisdiction of the instant cause. In so holding, however, the majority of the Court of Appeals has placed an untenable limitation upon the jurisdiction of courts of bankruptcy to enforce, in corporate reorganization proceedings, accountings under trust indentures securing bonds issued by corporations in reorganization. The majority has held, in substance, that the scope of the court's jurisdiction upon such accountings depends upon whether an indenture trustee's breach of trust is misfeasance or nonfeasance with respect to the trust *res*.

The Second Circuit Court of Appeals in four companion cases in this same reorganization proceeding unanimously held that the liability of an indenture trustee for a devastavit of misfeasance, such as a wrongful release or surrender of trust property, is to restore the trust *res*, that the right to enforce such liability is a right of the trust which follows the bonds, and that the bankruptcy court, upon an indenture trustee's accounting, has full jurisdiction to compel restoration of the trust *res* for the benefit of the bondholder secured creditors as a class irrespective of when they acquired their bonds (*Central Hanover B. & T. Co.* v. *President & Directors of the Manhattan Co.*, 105 F. 2d 130 (C. A. 2); *Manufacturers Trust Co.* v. *Kelby*, 125 F. 2d 650 (C. A. 2), cert. den., 316 U. S. 697; *Brooklyn Trust Co.* v. *Kelby*, 134 F. 2d 105 (C. A. 2), cert. den., 319 U. S. 767; *President & Directors of the Manhattan Co.* v. *Kelby*, 147 F. 2d 465 (C. A. 2), cert. den., 324 U. S. 866).

In the instant case, involving a substantially identical trust indenture, the majority of the Court of Appeals has held that where the indenture trustee's devastavit is nonfeasance with respect to the trust *res*, the bankruptcy court has jurisdiction if the bondholder secured creditors on the date the petition for reorganization was filed included "some at least" who bought their bonds before the date the indenture trustee's nonfeasance commenced (R. 1202; 202 F. 2d 560).[6]

[6] Petitioners interpret the majority decision to mean that the requirement that there be some such bondholders when the Debtor's petition for reorganization was filed qualifies or limits the jurisdiction of the bankruptcy court, but does not qualify or limit the liability of the indenture trustee; that the liability is to restore the *res* and is measurable, as in a case of misfeasance, by the amount of the loss sustained by the trust fund. This interpretation is implicit from the majority holding that the bankruptcy court had jurisdiction. If the indenture trustee's liability for a devastavit of nonfeasance gave rise to personal causes of action for damages in favor only of persons who owned bonds at the time of nonfeasance, the bankruptcy court, obviously, would have no jurisdiction over such personal causes having nothing to do with the *res* in *custodia legis*.

The decision of the Court of Appeals on the issue of jurisdiction is, therefore, in conflict with the four earlier decisions of the same Court of Appeals in the same reorganization proceeding. The instant case is in all respects basicly the same as the earlier cases. The only factual difference relied upon by the majority of the Court of Appeals is that the instant case involves nonfeasance of the indenture trustee, whereas, the earlier cases involved misfeasance.

The only ground stated by the majority for this distinction is that a trustee who loses part of the trust *res* by inaction or neglect does not "release or surrender" the lost trust property (R. 1200; 202 F. 2d 559). This is an artificial distinction without a difference. A trustee's "devastavit * * * may consist of any act or omission, every mismanagement, by which the estate suffers loss" (*Ayers* v. *Lawrence,* 59 N. Y. 192, 197). There is no logical distinction between an affirmative or negative, active or quiescent, release or surrender of trust assets. A trust *res* can be given up or lost as effectively by inaction as by action. In either case it is the trust estate which suffers the loss; in either case the recovery goes to restore or replenish the trust estate under the jurisdiction of the bankruptcy court.[7]

The decision of the Court of Appeals on the issue of jurisdiction is squarely in conflict with *In re Solar Mfg.*

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[7] See *May* v. *Le Claire,* 11 Wall, 217; *Isenberg* v. *Trent Trust Co.,* 31 F. 2d 553 (C. A. 9), cert. den., 279 U. S. 862; *Cherry* v. *Howell,* 66 F. 2d 713 (C. A. 2); *Marion Mortgage Co.* v. *Edmunds,* 64 F. 2d 248 (C. A. 5); *Greer Investment Co.* v. *Booth,* 62 F. 2d 321 (C. A. 10); *Boesenberg* v. *Chicago T. & T. Co.,* 128 F. 2d 245 (C. A. 7); *Citizens Banking Co.* v. *Monticello State Bank,* 143 F. 2d 261 (C. A. 8); *Redmond* v. *Commerce Trust Co.,* 144 F. 2d 140 (C. A. 8), cert. den., 323 U. S. 776; *Peterson* v. *Hopson,* 306 Mass. 597; *State Street Trust Company* v. *Walker,* 259 Mass. 578; *O'Beirne* v. *Bullis,* 80 Hun 570, aff'd sub nom., *O'Beirne* v. *Allegheny & Kinzua R. R. Co.,* 151 N. Y. 372, same case on second trial, *O'Beirne* v. *Bullis,* 2 App. Div. 545, aff'd, 158 N. Y. 466; Restatement, Law of Trusts, Secs. 197(b), 198(c), 198(d), 200.

Corp., 200 F. 2d 327 (C. A. 3), cert. den., 345 U. S. 940, where the Third Circuit Court of Appeals upheld, without qualification, the jurisdiction of the bankruptcy court to enforce, for the benefit of bondholder creditors as a class, an accounting by an indenture trustee for a devastavit of nonfeasance and rejected a contention that the right to recover for the devastavit was personal to the bondholders.

The Second Circuit Court of Appeals in the *Brooklyn Trust Company* case, *supra*, and the Third Circuit Court of Appeals in *In re Solar Mfg. Corp., supra*, held that the Bankruptcy Act expressly and inherently empowers courts of bankruptcy in corporate reorganization proceedings to enforce accountings under trust indentures. None of the pertinent provisions of the Act, expressly or by implication, justifies a conclusion that the jurisdiction is complete upon an accounting involving an indenture trustee's misfeasance, but qualified upon an accounting involving nonfeasance (See Statute, Appendix, *infra*, pp. 25-27).

3. The Court of Appeals has decided an important question of federal law in a way probably in conflict with decisions of this Court, or which has not been but should be passed upon by this Court.

In holding that the jurisdiction of the bankruptcy court is qualified upon accountings by indenture trustees involving nonfeasance, the Court of Appeals relied upon, and apparently believed it was controlled by, New York law under the rule of *Erie R. Co.* v. *Tompkins*, 304 U. S. 64.[8]

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[8] The Court of Appeals in its original decision, vacated after rehearing, relied upon *Smith* v. *Continental Bank*, 292 N. Y. 275, although it recognized that the rule of such case is unique and unsound (R. 1113-1115; 202 F. 2d 556-557). The subsequent majority opinion of the Court of Appeals refers to the *Smith* case as holding that in New York "a claim against a trustee for breach of his duty to protect the *res*, did not pass by transfer of the bond but remained the property of the transferer" (R. 1201; 202 F. 2d 559). The *Smith* case rule has been changed by statute in New York by amendment of Section 41 of the Personal Property Law, effective September 1, 1950 (McKinney's Consolidated Laws of

(Footnote continued on following page.)

This Court, however, has said that the *Erie* rule applies to "cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties" (*Guaranty Trust Co.* v. *York*, 326 U. S. 99, 109; *Levinson* v. *Deupree*, U. S. , 73 S. Ct. 914, 916; Hughes' Federal Practice, Vol. 17, Sec. 18514).

In the instant case, jurisdiction is based upon the Bankruptcy Act (*Brooklyn Trust Co.* v. *Kelby; In re Solar Mfg. Corp., supra*). State law, we submit, does not control courts of bankruptcy in determining the scope of their jurisdiction. "A bankruptcy court does not sit 'as another state court' and is not governed by state laws" (*In re V-I-D, Inc.*, 198 F. 2d 392, 396 (C. A. 7), cert. den., 344 U. S. 914).[9] The jurisdiction of courts of bankruptcy is "exclusive of the courts of the States" (28 U. S. C. former Secs. 41(19) and 371(6), as amended, 28 U. S. C. Sec. 1334).

Assuming *arguendo* that state law governs, the controlling state on the facts of this case would be Massachusetts, not New York.[10]

New York, Book 40, Sec. 41). The New York Law Revision Commission, recommending the amendment, stated that the *Smith* case rule is "contrary to the understanding and intention of the parties" and "at variance with the law of other states" (N. Y. Leg. Doc., 65(D), 1950). The *Smith* case has been roundly criticized (The Subsequent Bondholder and the Delinquent Trustee, 51 Col. L. Rev. 813; Right to Maintain Action for Breach of Trust After Transfer of Beneficial Interest, 59 Harv. L. Rev. 1286).

The law of Massachusetts is contrary to the *Smith* case (*Peterson* v. *Hopson*, 306 Mass. 597; *Cohen* v. *United States Securities Corp.*, 311 Mass. 152; *First Nat. Ins. Co.* v. *Salisbury*, 130 Mass. 303; *Dunning* v. *Bates*, 186 Mass. 123; *Hallett* v. *Moore*, 282 Mass. 380; *State Street Trust Company* v. *Walker*, 259 Mass. 578; *Young* v. *Haviland*, 215 Mass. 120; *Baker* v. *Allen*, 292 Mass. 169; *Pingree* v. *Comstock*, 18 Pick. (35 Mass.) 46; *Bouve* v. *Cottle*, 143 Mass. 310; *Milbank* v. *Littlefield*, 310 Mass. 55).

[9] See *Prudence Corp.* v. *Geist*, 316 U. S. 89; *Wragg* v. *Federal Land Bank of Orleans*, 317 U. S. 325; *Vanston Committee* v. *Green*, 329 U. S. 156; *Wright* v. *Central Ins. Co.*, 304 U. S. 502; *Holmberg* v. *Armbrecht*, 327 U. S. 392; *Board of Trade of City of Chicago* v. *Weston*, 243 Fed. 332 (C. A. 7).

[10] *Klaxon Co.* v. *Stentor Co.*, 313 U. S. 487; *Benton* v. *Safe Deposit Bank of Pottsville Pa.*, 255 N. Y. 260; *Mogul* v. *Jenkins Bros.*, 203 Misc. (N. Y.), 635; Beale on Conflict of Laws, Vol. 2, p. 1251. See footnote, *supra*, pp. 18-19.

4. The Court of Appeals has decided a question of importance to the public and jurisprudence generally in a way probably untenable, and has so far departed from established principles of law as to call for the exercise of this Court's powers of supervision.

Petitioners realize that decisions relating to the construction of trust instruments do not ordinarily merit review by this Court.

The merits of this cause, however, which were decided in petitioners' favor by the Master, were not passed upon by the District Court and were decided in the Court of Appeals in favor of the indenture trustee upon the basis of the majority construction of an indenture clause not there relied upon by the trustee. Had the trustee advanced the argument based upon such clause, which the majority Judges themselves advanced and then sustained, petitioners would have had an opportunity to be heard in reply (See, Petition for rehearing, R. 1253-1260). These circumstances indicate error and the need, in the interests of justice, for the exercise of this Court's power to remand the cause to the District Court for review upon the merits or for a review upon the merits by this Court.

This cause, moreover, involves a professional trustee under a trust indenture securing bonds sold to the public. Judge Frank, dissenting, states that the majority Judges have used "much ingenuity in interpreting ambiguous provisions of the indenture, with (I think) marked generosity to the trustee", that the majority decision "debases the noble word 'trustee', allows it to become a tricky decoy to catch and injure innocent investors", is more than passing "strange", "without precedent" and "against the precedents" (R. 1215, 1222-1223, 1234; 202 F. 2d 566, 569-570, 575).

The majority of the Court of Appeals, with admitted doubts and much speculation about the intent of the parties, has held that the intent was to give the indenture trustee

complete immunity against liability for any nonfeasance with respect to the trust *res*.

In reaching this conclusion, the majority, although recognizing that the "duty to care for the *res*" is inherent in a trust relationship (R. 1209; 202 F. 2d 563), has laid down two untenable rules governing trust indentures made to professional trustees to secure corporate bonds: (1) Exculpatory clauses must be strictly construed so as to resolve ambiguities in favor of the trustee draftsman of the instrument and against the bondholders; (2) A provision giving the trustee complete immunity against liability for any nonfeasance with respect to the trust *res* is not contrary to public policy.

These rules violate established principles of law.

The principle "rigorously applied to the construction of trust deeds * * * securing bonds" is that "ambiguous phrases are to be taken most strongly against" the draftsman.[11] This principle is especially applicable to exculpatory clauses.[12]

The second of the rules laid down by the majority is equally unsound. There is doubt whether an indenture clause exempting a trustee from liability for ordinary negligence is valid.[13] Settled, however, are the principles that a clause exempting the trustee from liability for gross negligence or wilful misconduct is invalid and contrary to public policy, and that continued nonfeasance, amounting

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[11] *Rothschild* v. *Rio Grande Western R. Co.*, 84 Hun 103, 109, 17 App. Div. 635, aff'd, 164 N. Y. 594; *Enoch* v. *Brandon*, 249 N. Y. 263, 268; *Prudence Co.* v. *Central Hanover*, 237 App. Div. 595, 601, aff'd, 261 N. Y. 420; *Harvey* v. *Guaranty Trust Co.*, 134 Misc. 417, 428, aff'd, 229 App. Div. 774, 256 N. Y. 526; *Sternberg* v. *Drainage Dist. No. 17*, 44 F. 2d 560, 562 (C. A. 8).

[12] Restatement, Law of Trusts, Secs. 174, 222; Scott on Trusts, Vol. 2, Sec. 222.2.

[13] *Litchfield* v. *White*, 7 N. Y. 438; *Hazzard* v. *Chase Bank*, 159 Misc. 57, aff'd, 257 App. Div. 950, 283 N. Y. 682, cert. den., 311 U. S. 708.

to supine or reckless indifference to the interests of the beneficiaries, constitutes gross negligence or wilful misconduct.[14]

A provision giving a trustee complete immunity against liability for any nonfeasance with respect to the trust *res* would embrace gross or wilful negligence, be wholly repugnant to a trust and a fraud upon the investing public.

The majority, indulging in the "guess" that purchasers of bonds secured by trust indentures "expect very little" "care and attention" from the trustees, has held in effect that a court of equity, absent a statute to the contrary, must affix to such a complete immunity stipulation its seal of good faith and fair dealing (R. 1211; 202 F. 2d 564). This is indeed a rule which, as Judge Frank said, debases the word "trustee", is without precedent and contrary to the precedents.

There are outstanding in the hands of the public billions of dollars of trust indenture securities.[15] The decision below, if permitted to stand, will, we submit, have a wide-

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[14] Restatement, Law of Trusts, Sec. 222; Scott on Trusts, Vol. 2, Sec. 222.3; *Rae* v. *Meek*, 14 App. Cas. 558, 572-573; *April* v. *April*, 272 N. Y. 331, 340; *Hazzard* v. *Chase Bank, supra; Browning* v. *Fidelity Trust Co.*, 250 Fed. 321, 327 (C. A. 3), cert. den., 248 U. S. 564; *Citizens Banking Co.* v. *Monticello State Bank*, 143 F. 2d 261, 267 (C. A. 8); *Seelig* v. *First Nat. Bank of Chicago*, 20 F. Supp. 61, 68 (D. C. N. D. Ill.); *Digney* v. *Blanchard*, 226 Mass. 335, 337; *Tuttle* v. *Gilmore*, 36 N. J. Eq. 617, 620-622; *Conover* v. *Guarantee Trust Co.*, 88 N. J. Eq. 450, 460-462, aff'd on opinion below, 89 N. J. Eq. 584; *State* v. *Comer*, 176 Wash. 257, 263-265; *Liberty Title & Trust Co.* v. *Plews*, 142 N. J. Eq. 493, 505-509; *Straus* v. *Chicago T. & T. Co.*, 273 Ill. App. 63, 71; *Kitchen Bros. Hotel Co.* v. *Omaha Safe Deposit Co.*, 126 Neb. 744, 754-755; The Trustee and the Trust Indenture, 46 Yale L. J. 737, 763, 782-783; Liability of the Trustee under the Corporate Indenture, 42 Harv. L. Rev. 198, 244-245.

[15] In 1934 securities outstanding under trust indentures totaled $37,000,000,000 (The Trustee and the Trust Indenture, 46 Yale L. J. 738). In 1944-1949 new corporate debt represented by bonds totalled $26,000,000,000 (The Subsequent Bondholder and the Delinquent Trustee, 51 Col. L. Rev. 813, n. 3).

spread adverse influence upon such securities, tend to encourage complaisance by indenture trustees, to open up a wide avenue for them to escape liability for breaches of trust, and to destroy the confidence of the investing public in the word "trustee". Application in other courts of the untenable rule of interpretation of trust indentures established by the decision below may alone tend to undermine or nullify the statutory safeguards established by the Trust Indenture Act of 1939 after a comprehensive study and report by the Securities and Exchange Commission (15 U. S. C. Sec. 77aaa et seq.).[16]

The majority decision, written by Judge Learned Hand, stands in striking contrast to the following principles enunciated by Judge Learned Hand in earlier cases:

> "* * * the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear and which all collectively create." (*Helvering* v. *Gregory*, 69 F. 2d 809, 810-811 (C. A. 2), aff'd, 293 U. S. 465.)

> "* * * That we should not so construe the intent of the parties as to foil their venture, is a cardinal principle of all interpretation." (*Manufacturers Trust Co.* v. *Kelby*, 125 F. 2d 650, 654 (C. A. 2), cert. den., 316 U. S. 697.)

> "* * * I do say that he (a trustee) may not strip himself of all his fiduciary duties after peppering a whole document with fiduciary verbiage. Complaisance after notice may bring upon him a just charge of 'gross negligence' or 'bad faith'; and that will serve." (*Clarke* v. *Chase Bank*, 137 F. 2d 797, 802 (C. A. 2), dissenting opinion.)

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[16] The majority, in guessing that purchasers of bonds "expect very little" "care and attention" from the trustees, and in stating that "abuses" have not "induced legislatures to intervene" (R. 1211; 202 F. 2d 564), overlooked the Trust Indenture Act of 1939, and the abuses which caused Congress to intervene.

"* * * the fiduciary element * * * is peculiarly intense in the case of a trust * * * a trust for the benefit of a numerous and changing body of bondholders appears to us to be preeminently an occasion for a scruple even greater than ordinary; for such beneficiaries often have too small a stake to follow the fate of their investment and protect their rights." (*Dabney* v. *Chase Bank*, 196 F. 2d 668, 670-671, C. A. 2.)

CONCLUSION

WHEREFORE, it is respectfully prayed that this petition for a writ of certiorari be granted.

Respectfully submitted,

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July 28, 1953.

APPENDIX

BANKRUPTCY ACT

CHAPTER IV

Sec. 24(a), 11 U. S. C. Sec. 47(a). The United States courts of appeals, in vacation, in chambers, and during their respective terms, as now or as they may be hereafter held, are invested with appellate jurisdiction from the several courts of bankruptcy in their respective jurisdictions in proceedings in bankruptcy, either interlocutory or final, and in controversies arising in proceedings in bankruptcy, to review, affirm, revise, or reverse, both in matters of law and in matters of fact: *Provided, however,* That the jurisdiction upon appeal from a judgment on a verdict rendered by a jury shall extend to matters of law only: *And provided further,* That when any order, decree, or judgment involves less than $500, an appeal therefrom may be taken only upon allowance of the appellate court.

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SECTION 77B

Sec. 77B(b), (9), 11 U. S. C. Sec. 207(b), (9). A plan of reorganization within the meaning of this section * * *; (9) shall provide adequate means for the execution of the plan, which may include * * * the satisfaction or modification of liens, indentures, or other similar instruments, * * *: *Provided,* That the judge shall scrutinize and may disregard any limitations or provisions of any depositary agreements, trust indentures, committee or other authorizations affecting any creditor acting under this section and may enforce an accounting thereunder * * *.

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Sec. 77B(h), 11 U. S. C. Sec. 207(h). Upon final confirmation of the plan, the debtor and other corporation or

corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relevant thereto, under and subject to the supervision and control of the judge, and the property dealt with by the plan, when transferred and conveyed by the trustee or trustees to the debtor or the other corporation or corporations provided for by the plan, or, if no trustee has been appointed, when retained by the debtor pursuant to the plan or transferred by it to the other corporation or corporations provided for by the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, and the court may direct * * * any mortgagee, the trustee of any obligation of the debtor, and all other proper and necessary parties, to make any such transfer or conveyance, * * *.

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CHAPTER X

Sec. 212, 11 U. S. C. Sec. 612. The judge may examine and disregard any provision of a deposit agreement, proxy, power or warrant of attorney, trust mortgage, trust indenture, or deed of trust, or committee or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder, may restrain the exercise of any power which he finds to be unfair or not consistent with public policy and may limit any claim or stock acquired by such person or committee in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor.

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Sec. 216(10), 11 U. S. C. Sec. 616(10). A plan of reorganization under this chapter— * * * (10) shall provide adequate means for the execution of the plan, which may include: * * * the satisfaction or modification of liens, the cancellation or modification of indentures or of other similar instruments; * * *.

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Sec. 227, 11 U. S. Sec. 627. The court may direct the debtor, its trustee, any mortgagees, indenture trustees, and other necessary parties to execute and deliver or to join in the execution and delivery of such instruments as may be requisite to effect a retention or transfer of property dealt with by a plan which has been confirmed, and to perform such other acts, including the satisfaction of liens, as the court may deem necessary for the consummation of the plan.